Event Transcript
Financial Stability and the Problem of Too-Big-to-Fail Financial Institutions

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Adam Posen: There are several fundamental questions which we hope they will address at least in part. We sit here in the United States and look at one of the most diverse, deepest, least concentrated banking systems in the world coming from the United Kingdom where I served at the Bank of England in the last few years. You have essentially five big banks running the entire financial system. It's a very different kind of experience. And yet, there is good reason for us to be concerned about the regulatory implications and the economic stability engendered by institutions that are very large—financial institutions are very large.

At the same time, there were a number of people and myself among them, I must admit even though I'm generally a strong regulation person, who a dozen years ago were saying, "Well hell, the savings and loan crisis came because we had all these rinky-dink little institutions that we couldn't keep track of and they didn't know how to behave." Maybe it's like the old train saying, "Put all your eggs in one basket and watch that basket."

So not to say that's right, but it's an interesting question. And when we look across countries, as is of course part of the mandate here at the Peterson Institute, we look at Switzerland where two very large banks seemed to have been a very real problem. But we look at Canada where it seems to have four very large banks and it has gotten through very smoothly.

So the issue is not self-evident. There are reasons and economic terms, it seems, why there's a natural logic for at least some institutions to become quite large. On the other hand, there is an academic literature that has not found as convincingly obviously evidence of economies of scale or scope as some people might have expected. So there's a lot to play for.

But particularly with this distinguished group of policymakers and influential people, we'd like to focus on the practicalities I think, I hope, if too big to fail is a problem. What does that mean for what kinds of institutions? How do you enforce that? What are the cost and benefits? Can you get around that by putting on strict size limits? Is it capital requirements? Is it different forms of supervision? Is it you really have to change law? Is it credible to change the law in a way that will automatically work?

Anyway, thank you all for joining us. And now for the first 40 minutes or so, I'll turn over to Simon for our conversation.

Simon Johnson: Thank you very much, Adam. Thanks for the opportunity to have this discussion at the Peterson Institute and thanks everyone for coming. I think my view is we're going to have a fascinating and perhaps somewhat unique discussion this morning, although hopefully, the first of many.

Let me just very briefly introduce our three panelists and put the first opening question to them. We've tried to mix everything up for you today in terms of where they sit as you look at them. This is supposed to be a discussion across the political spectrum with many unexpected points perhaps emerging.

On your left is Sheila Bair, former chair of the Federal Deposit Insurance Corporation (FDIC) and the author of an excellent book, *Bull by the Horns* that I highly recommend for anyone concerned about the financial sector and what has happened with regard to our biggest banks in this country.

Next to her in the middle is Jon Huntsman, a former governor of Utah, former ambassador, US ambassador to China and Singapore and also a very experienced executive in the nonfinancial sector including with Huntsman Corporation.

And on your extreme right is Senator Sherrod Brown, a senator from Ohio, a member of the Senate banking and finance committees, and a senator who introduced in 2010 an amendment to Dodd-Frank—an amendment that didn't ultimately succeed, but would have made our largest banks smaller and less leveraged. And he continues to very effectively press the case for making our financial systems safer and addressing the issue of big banks.

But let me begin with the first question and I'll start with Sheila and then take you to Jon and Sherrod. There is a view that is expressed more as is in public by some Wall Street executives and people who work with them that there is actually no such thing as too big to fail that the too big to fail either didn't exist or it's been addressed and it's somewhat a figment of the statistical imagination.

So let's start by understanding your positions. Is there such a thing as too big to fail? How should we think about that? Sheila.

Sheila Bair: So there is something called too big to fail. Why do we do these bailouts if there weren't institutions that the government decided that if they fail in a normal bankruptcy process it would hurt the rest of the economy? So clearly, we did have too big to fail. I think we still do. I don't think we'd get rid of it until the market is convinced that this is over, that these big institutions no longer have to put on the government, if they get in trouble. Their creditors and their shareholders are going to be taking the losses, not taxpayers. They will not have to put their money at risk.

I mean certainly you could see a real tangible evidence of too big to fail as the crisis accelerated and people became increasingly concerned about the safety of the banking sector. We saw uninsured deposits fly out of community banks, frankly, and go to Bank of America (B of A), JP Morgan Chase; the banks that reviewed as too big to fail.

So I don't think we would have seen that dynamic if the market itself and the public itself wasn't viewing some of these institutions as institutions that government would not like to fail. And this creates an inherent competitive disparity. That's why their funding costs tend to be lower because, again, folks think that if they've—especially their debt, their unsecured debt, that there's a put on the government, they're not going to have to take losses.

So it very much exists. It exists in a period of crisis. It encourages risk taking if you're an institution and you think with a lot of leverage you can have really big returns for a time when times are good. And when the losses come, you're going to put that on the government. You're going to go out there and take a lot of risks. That's just basic economic incentives.

So not only does it create competitive disparities and puts taxpayers unfairly at risk, but it excused risk taking. It excused investment dollars of large institutions and gives some positive incentives to take risks that they would not otherwise undertake.

Simon Johnson: Okay. Thank you, Sheila. Jon.

Jon Huntsman: Well, I think you have to look at the numbers. You know I come at this not as a regulator, not as a member of the Senate, but as someone with a varied background. And I see it through the lens of whether or not what we are doing in the financial sector is actually getting capital to the innovators and the entrepreneurs who keep the machine running.

And as we're getting back on our feet economically, we had to see this period as a moment to simplify, to get risk out of the system. And when you've got six institutions; the combination of which at least in assets are equal to 63 to 64 percent of our GDP. Not one of them can afford to go under because of the catastrophic effect it would have on our own economy. That then becomes something that is too big to fail.

Does that promote increased risk taking within in terms of maybe trading activities or the kinds of financial instruments that are used? You'd have to say probably. Is there a subsidy that goes along with that view that they are too big to fail when they get a notch or two on the credit scale above what they otherwise might get and 80 basis points to 100 basis points advantage in terms of cost of capital?

All of that plays into the mix when you look at the health and competitiveness of something as important to our economy as our financial system. So is this a time to look at banks that to my mind are too big to fail? What it is doing to overall competitiveness if in fact it is getting capital out to our innovators and creative types in ways that would allow us to rebuild ourselves during a time of, I think, continued economic vulnerability? Yeah, I think all the above is true.

Simon Johnson: Okay. Thank you. Sherrod.

Sherrod Brown: Only add a couple of points. I think both Sheila and Jon are right about that, that the markets—that 70, 80, and 90 basis points advantage that the six banks have. Bloomberg had a recent story upwards of $80 billion and additional profits as a result of the market's reaction to too big to fail.

Tom Hoenig was in my office one day a year or so ago talking about this and sort of the implicit subsidies. And one of the things he thinks it leads to is that this bias that we seem to have as an economy now as a nation reemphasizing financial services over manufacturing governor which your families have been involved. And you look back—it's not just—you look back on financial services 15 to 20 years ago.

These six largest banks made up. Their combined assets were something like 18 percent of GDP; today they're 62, 63, 64 percent of GDP. You look at what's happened with the relative position of manufacturing and financial services 30 years ago different measurement as a percent of GDP obviously, its revenues. But banking was about 10 percent of GDP 30 years ago. Financial services were about 10 percent of our GDP in terms of revenues and manufacturing is about 25 percent. And that's pretty much flipped that manufacturing is now only about 11 or 12 percent, maybe slightly less than that. And financial services are in the mid-20s.

I mean look where that got us in terms of ticket to the middle class with so many working families where manufacturing was their opportunity. And financial services is a great job creator in all of that, but nothing compared to what manufacturing was. And you know wealth is created by making it, or growing it, or mining it. And we aren't making enough. We aren't making enough things now. And part of the reason, I think, is the implicit subsidies and the bias in our economic/political system because of financial services.

And I would add one other point and that's not just the economic power that the financial services that these six large banks have. It's really the political power they wield. And Sheila has just done yeoman's work as a regulator. I wish there were a lot more of her in the government today and yesterday too for that matter; that really understood the economic power or the political power of the large banks and could equalize a little better.

Simon Johnson: Thank you. And I would just like to recognize Tom Hoenig who's in the second row of the audience and recommend to all of you the numbers that he and his colleagues had calculated at the FDIC with the regard to the size of banks comparing across countries and also the right way to think about capital and capital level in those banks. We might come back to that in the Q&A.

So the three of you I think have given us completely complementary and very consistent views with slightly different emphasis or words, but I think with one picture. We're concerned about what has happened to our financial system and the way in which these very large banks have become so powerful and what that does to the real economy.

So the next question then is what should we do about it at least at a broad level in terms of policy and thinking about how to approach this issue? And we'll talk about some of the details and we can have questions about more of those details no doubt. Broadly, let me start this round with Jon Huntsman. What is your broad perspective in terms of sensible policy that would move us responsibly in the right direction on this issue?

Jon Huntsman: Well, look where we are and what has been tried. So after the catastrophic years 2007 to 2010, we get out of the situation driven by fear, driven by the consumers who are no doubt making the arguments with the members of Congress that it can't continue. We have Dodd-Frank.

And despite their, I think, sincere attempts, I mean too big to fail is even written in the very preamble of Dodd-Frank, 16 titles, 900 pages, 3000 pages of proposed regulatory fixes. Based on one estimate, it would take 2,200,000 hours per year in order to live up and comply with those. And we're not done yet.

So the answer is kind of moving out in real time. But I fear it's going to sidetrack our financial model in ways that place too much of a burden on the local and regional banks who simply can't step up and pay for and embrace the kind of regulatory weight that Dodd-Frank is calling for.

I would say at some point, we're going to have to measure the relative level of risk that these banks give and then how you address it, how you counterbalance the implicit subsidy that is being covered by the taxpayers. My guess is you either look at the size of the banks based upon the percentage of GDP and keep them within a certain size. And Sherrod mentioned, 20 years ago or so and what was Goldman Sachs in those days maybe $200 billion in sales; today a trillion bucks. Are we better off or worse off as a result of the growth? I don't know, but that ought to be looked at.

I think it's important to analyze and share with the American people the risk that we are carrying today. I don't think that's fully understood. But I believe with that, we had to work on taking the subsidy out of the system. That ought to be I think our first order of business. I'm not sure how that is done. Sheila would have much a better feel for that. But my guess is imposing something like a fee on banks that until they right size themselves to a size where they're not too big to fail, they have to pay into some sort of account that would ameliorate to some extent the risk that the taxpayers are carrying.

There are other discussions maybe looking at the way the FDIC measures their own level of risk by way of looking at maybe asking for more in the way you measure in price risk in your premiums. But all of these ought to be part of the work we do in the next year in first and foremost sizing up the risk for the American people, second of all, looking at realistic ways to correct that.

It's not an easy call. And I think the whole discussion is up against some entrenched interest that will make it a very, very difficult thing to do. But I can tell you this having had more than my share of town hall meetings in early primaries days, but we won't get into that part.

There is a real connection by people. And again on both sides of the political aisle, they get the importance of this issue. And I think they understand it through the prism of their local community banks with whom many of them have carried on very personal relationships. And when they see that model threatened by an overhang of bureaucracy and larger banks that have some implicit backstop by the American people access to discounted capital, I think that becomes very worrisome for them. And they get the part about how this may run counter to our long-term competitive interest.

Simon Johnson: Okay. Well, Sheila, let me take the point of insurance and paying for insurance. You say in your book, I believe, clearly and many times, that when we have insured deposits which we've had since the 1930s there's a premium that you have to pay for that. And there's also a lot of regulation oversight that comes with that. Now that's for the part of financial system which has retail deposits.

Should we think about some sort of insurance fee or premium for the banks, the big banks, more broadly, not with you perhaps to making that a permanent arrangement, but to put pressure on them as the governor said to become smaller and to right size themselves?

Sheila Bair: Well, we actually push that as part of Dodd-Frank. So for the deposit insurance premiums are risk adjusted. And so you do pay more if you have a risk to your profile. But deposit insurance premiums are also there backstop deposits. So I don't think we want a new insurance system for other liabilities. We clearly don't want that.

But I think it's completely appropriate to assess a fee on these large financial institutions. A lot of the high-risk activity occurs outside of the insured bank, not inside. So they have a fee that's based on how risky they are that requires them to internalize the external cost that they impose to the rest of us and the subsidy advantage they have over smaller institutions. So we made that case in the House.

We got a $150 billion fund in the House. It went to the Senate. And unfortunately, I run into the same problem that you run in with yours in terms of resistance from the treasury department. And so it was dropped in the Senate. But I think that would have been a huge boon to give the FDIC authority to do a risk-adjusted fee not to guarantee liabilities to provide working capital if you do have to resolve on these very large institutions and again make them internalize the risk that they pose to the system. So I still think that's a good idea. And it could definitely help address the skewing of investment capital and level the playing field between larger and smaller institutions.

Simon Johnson: And Sherrod, on the issue of size, no one has been as outspoken and also as effective as you on really making the debate more about size and correcting size. Could we do it with a fee? Do we need a size cap, a restriction of some kind? Or what's your perspective on that?

Sherrod Brown: I mean we've advocated the restrictions on size obviously. But there are several kinds of avenues we're approaching. And we're seeing what—and

Jon and I were talking about this a little bit before. And we're seeing this increased interest, I think, in large part because the public. I like what you said about the public seeing it through the prism of community banks and those are the people they tend to know and certainly don't blame for the financial crisis rightfully so.

But I think that what has happened is members of Congress, political pundits, media people, and certainly people like a lot of you that think about this have looked at this a little bit differently from three or four years ago; build the cap to cap non-deposit liability. The Brown–Kaufman amendment got 33, 34 votes; three Republicans voted for it. One of them is not there now, so we're down to two except we're not because we're talking [inaudible 17:46] in our office who many of you know is we've been talking to literally 10 Republican senators who have interest in taking one of these avenues.

It may be how do we do capital standards and tier them so that community banks get probably some relief and mid-sized regional banks like in my state Huntington or Key or Fifth Third would be sort of a second tier and then the largest banks would have obviously a higher level of capital and addressing the issue of the quality of capital. The quality of capital for community banks is more liquid and more solid, if that's not real technical term, but then what Wall Street do or what the big six use for their quality of their capital.

And so I think we look at that and then I think we look at the whole issue of restricting the amount of debt that a single company could take on relative to the economy. I don't think we restrict ourselves to one of these paths. Senator Vitter's major interest seems to be on capital standards. I'm fairly agnostic on preference of the two. Capital standards are actually limiting—they're restricting the amount of debt that a single financial enterprise can hold or take on.

But I think we approach each of these because I think we—I mean it's a question of building support in the Senate and in the House. I mean we are today in a place that I wouldn't have imagined a year ago we would be because the public and the policymakers are starting to figure this out and starting to pay more attention and I think partly because of the fear of what really could happen as these banks have gotten larger and larger.

Simon Johnson: That's my next question which is about the politics. So Governor Huntsman said, and Senator Brown said when you talk to people and you try to get their votes, that at some level they really understand that the damage that's been done by Wall Street and by very large financial institutions is enormous. And it's affected every community.

And yet perhaps, and hopefully these ideas are now starting to get traction in Washington, it's been a long time that the crisis manifests itself in 2007; 2008 was terrible; 2009 was perhaps worse; and the legislation passed in 2010.

So let me ask each of you. I'll start with Sheila on this around. Why have the politics been so slow to respond to what is not in my view some sort of dangerous populism, but actually convergence of sensible policy thinking and what people outside of Washington want to happen? Why the slow reaction?

Sheila Bair: Well, you know, financial services just got too big. They got too big as part of the economy. They got too big as part of the political system. And day in and day out, large financial institutions have a lot of lobbyists and law firms and things here. And I don't fault them for that. They're in the business of making money. And so they, like everybody else who comes to Washington to try to advocate their case. But it's lopsided. There's the counter-pressure of that populist appeal of what the vast majority of the population really wants to happen. Meaningful reform doesn't happen because you have this lobbying pressure.

I think we need more leadership from the administration too. I don't think we got the leadership that we needed during Dodd-Frank and that needs to be part of the solution and we're still not, that I see, getting much leadership from the administration on these issues. So the capture as a lot of people is bipartisan. And when I say capture, I'm talking about cognitive capture. It's not so much corruption. It's just listening too much to large financial institutions that people who represent them are not enough to the people out on Main Street who want this fixed.

Simon Johnson: Sherrod.

Sherrod Brown: I think she's exactly right. The Brown–Kaufman amendment got three votes out of the banking committee including mine and that tells you something. I think Sheila is right. I don't think that it's the corruption of the system, but it's not really the corruption of individual senators and that sounds a little self-serving as an individual senator.

But I really do think it's so much—in many ways this town sings with an upper class accent and in many ways what we hear every day we hear more from just—until recently until people like Simon if stepped up and people like Tarullo and Richard Fisher and people who do financial regulation of some sort for a living have—most of what we heard from economists, from people who are in the know, who are people that were supposed—to the serious mostly men, unfortunately, in this town on these kinds of issues and in New York. But that's kind of what we hear all the time.

So it's not so much corruption as it is who we listen to unfortunately. And that's the importance to some of you in this audience including the three sitting next to me who have helped to educate people like me. I got on the banking committee without any real banking background. I read *13 Bankers* and it's as good a case as I've ever read on what we do about restricting the amount of debt and what we need to do.

The courage that Governor Huntsman has shown on this issue when it's not necessarily been popular in some parts of his party and what Sheila has done. I mean I will always sing her praises and as I said I wish there were more of her. But I think the politics has changed, but I think it's not nearly there yet. I think if we did that amendment freestanding on the senator floor again, we'd get 45 votes.

I think that a number of members, not a majority, but a number of members of banking committee have said they either made a mistake or they would vote our way this time, I think. And Senator Grassley and I sent a letter to the attorney general asking him what they wereexactly — we use the term because everybody plays off the same terms—we used the term too big to jail because they wouldn't—I know that wasn't really very clever—but they wouldn't want us—

Simon Johnson: Did you come up with that term?

Sherrod Brown That's a really clever term. It didn't look they were willing to prosecute as they should have been because what would that do to the financial markets and what would that do when one of these institutions is so large that it could ripple through the financial system and cause damage to the economy. It's evidence and it's also anecdotal when we're seeing these kinds of stories and these kinds of things happen that don't allow the justice system and the political system to work the way that they should. That's nothing new, but again, I'm hopeful because I've seen much more progress in the last 12 or 18 months than I've thought possible at this point.

Simon Johnson: Well, I think it was—I don't know who coined the phrase too big to jail. But I know Lanny Breuer who was at that point a senior official in the Department of Justice said in public that it was difficult to bring criminal prosecutions against some large financial institutions for fear of the consequences and that struck me as being fundamentally at odds with the principles of both justice in general and even how the Department of Justice justifies its budget which starts with words from Thomas Jefferson about how everybody needs to be equal before the law.

But on the politics, Jon, do you agree? Is it changing or is it changing in a meaningful way? I mean, yes, people are angry. People are upset. Perhaps, more people understand these issues. But is there a movement or is there a Teddy Roosevelt-type moment when across the political spectrum people agree on an issue enough to actually—for that to shape elections and for that to change policy?

Jon Huntsman: I think we'll get to that point. And it may take another election cycle for us to get there. It's got to rise. It's got to resonate. It has to find its proper cue in the hierarchy of issues. I mean it can't be number 10. It's got to be number three or four in order for people to really start paying attention.

But it's been fired by passion and emotion; Tea Party, Occupy Wall Street. Where did they come? They come together on this issue. And they come together on this issue because they sense that the market is rigged against them that we don't have equal outcomes, that we don't have equal opportunity. We don't have a level playing field. And I think that stirs a lot of passion out there when they feel the system is rigged against them. And that's kind of where we find ourselves.

So you take the passion and emotion that really I think was part of firing the early Tea Party movement and certainly Occupy Wall Street. And that then sort of settles out into the fact finding and that's where I feel we are today. How do you take the passion and emotion around a very legitimate issue and begin then to sort it out based on the facts, the risks, the fixes, and the real policy solutions? Like Sherrod and others are brave enough to tackle. And that would probably take a little bit of time.

But I'm actually surprised, Simon, that this has moved as quickly as it has. You don't have to go back too far to see the people in the streets talking about this issue, the response to Dodd-Frank as the old Yiddish saying goes; man plans and God laughs. And the aftermath it was a real concern. I felt it on the [inaudible 26:32] during the last presidential cycle.

I talked about it in our town hall meetings. And I could feel there was a very deep and meaningful connection with this issue. I think it's going someplace. It has legs because it's based on a legitimate imbalance in our system. And people feel that something as important as our financial sector is not as healthy today as it should be. It is the sword of Damocles that continues to hang over us right now and it needs to be addressed.

Simon Johnson: Now that leads to my other—one more round of question before we go back to Adam and the Q&A. Let me start with Sherrod and Jon and then Sheila.

So we've talked about the general problem and you've all expressed broad ideas about what should be done and hope at least that the political moment is coming. But this year, the 100th anniversary of the founding of the Federal Reserve, it strikes me and some others that the Fed and Dodd-Frank acquired more powers. There is, of course, also the Financial Stability Oversight Council which is chaired by the Treasury. But again, the Fed is very important in that structure.

What should we be pressing the Federal Reserve, the Board of Governors level for example? What should we be pressing them to do in terms of either policy actions or studying, understanding, measuring the scale of the problem? Is there something the Fed can take the lead on in our existing framework while we wait for Congress to act or wait for different people to be elected? Can the Fed take this on? Should the Fed take this on? Is the Fed undermining its broader legitimacy if it continues to refuse to take this on? Sherrod.

Sherrod Brown: I don't know the answer to that. I would start with a couple of comments. I ask Jack Lew in the Finance Committee hearings on his nomination about his role on FSAC and what he should be doing at Treasury and was less than overwhelmed by his answer on even recognizing the advantage, the implicit subsidies that the largest banks get. So I think we have a ways to go there. I think the Fed probably is not in a much better position than that.

But I think it's partly up to us to give them the evidence. One of the things that we're working on with Senator Vitter is we passed a bill through the Senate and the House; somebody, staff at the House. But then we wrote a letter to the Government Accountability Office (GAO) asking for a study aid which will take about a year, we think. But we hope we can accelerate parts of it to really quantify the advantages that they get in this sort of implicit subsidies. That will help us.

I think it's really continued pressure from those of us in the Senate and in the House that care about this and the Fed and the Secretary of Treasury. I'm very concerned about—Dennis and I were talking about this about whom the President or the Secretary of Treasury whoever actually does the hire there for the number two person, that it's not somebody from Wall Street, that it's somebody with a different perspective kind of whispering in Secretary Lew's ears.

I don't question Secretary Lew's motives at all. I just think that we've seen that kind of bias in administrations surely of both parties. But I think partly when I heard Governor Huntsman say and we're sort of saying the same thing about the speed, I mean speed in Washington terms at how fast this has moved.

I think it's partly that what happened with JP Morgan Chase and their loss of $6 billion or $7 billion, that with the CEO, considered one of the best CEOs in the country, perhaps of any business, certainly in the banking industry that even the management at that institution can really understand what was going on. And it really does play into not just too big to fail but too complicated to manage, too difficult to regulate.

I mean there's no—I'm a guy that believes. I mean I wear in my lapel a depiction of a canary in a birdcage. It was given to me at a Workers' Memorial Day rally, that 100 years ago when people are working in coal mines. You know the story of the story of canary in the mine. They had no union to protect them and the government didn't care enough to protect them. I mean I believe in regulation on health and safety and Medicare and all the other things.

But I also understand that regulation on Wall Street alone doesn't do it. And when progressive see that it's got to be more than good regulations partly their regulatory capture. Partly, it's just difficulty and the opaqueness of it and the complexity of it. And if management of these firms can't figure out all the new financial instruments that are created by these brilliant young men and women coming to Wall Street, the managers, the company CEOs can't understand it and how are the regulators paid so much less and usually much younger and less experienced going to understand this. So I mean it's pretty clear. It's got to be a broader attack on it than just the traditional way we did it. And I think more people are seeing that.

Simon Johnson: Jon, the Fed, the Federal Reserve, should we put pressure on them to take this more seriously?

Jon Huntsman: Yes, it's a role to play. I think given where Sherrod is in some of the [inaudible 31:33] I think the Senate and Congress that's probably the best place to at least begin to analyze and sort through the realistic options we have.

I mean go back to 1930. I mean look at the Federal requirements here in 1933 and so on. That didn't stop the catastrophe. Without a doubt, there's a role to be played, but listen. This is playing out in real time. And we have to remember that the contagion effect of what is happening in the eurozone.

So if Greece can't get its act together and the debt issue isn't properly addressed and Spain, Portugal, Italy, and the rest of the major banking centers of Europe are then brought into this, then we start feeling the effects here. And of course, the Chinese will feel the effects there and the major banking centers in Asia.

And that's why given the risk that is still present in the global marketplace, this isn't just an academic discussion. This is playing out in real time. And therefore, I think, as quickly as we can get to some assessment of risk what that is, how you then begin to ameliorate that risk, something along the lines of a living trust, maybe that should be our work for the next year led by Sherrod and Senator Vitter and others.

What is the risk? And what are the implications of an institution that goes bad in terms of the bankruptcy processes? Is the market able to absorb it or not by the implicit subsidies? This all needs to be broken down into fact that we can then base policy on, so I think the work for the next year is pretty clear. Take the evidence out there. Shape it into information that is adjustable. Begin the heightening of awareness at all levels of society. And begin to think about realistic policies that can then be put forward. And that will take out a couple of years.

But let's not forget we're in a global marketplace that is still feeling some great uncertainty and real insecurity both in Europe and to some degree in Asia, certainly with Japan, the banking sector in Japan. And in China, it's hard to know. But my guess is with commodity prices will likely be impacted by their stimulus spending. And oh wait. Nick Lardy is here who knows it as well as anybody. A lot of overcapacity. A lot of manufacturing put up in recent years roads to nowhere. You're probably going to end up with some non-performing loans at some point. It's hard to know what stress and strain that will put on the Chinese banks. But we've got a lot playing out in the financial centers of the world that have immediate connections with our own institutions here at home. So it's a real issue.

Simon Johnson: Sheila, do you see any signs in the Federal Reserve taking this on in the short term or are they just sitting back and waiting for events to unfold around them?

Sheila Bair: Well, it doesn't seem so. And somewhat to my disappointment, Dodd-Frank did give the Fed and the FSAC and the Fed and the FDIC jointly really substantial powers to order restructure of institutions that they deem cannot be resolved with bankruptcy without systemic impact or the divestiture. The willingness to use those tools, I don't know in the near term. I don't think that's there. And it maybe that Congress—if that's the solution that we decide on, Congress needs to act again.

But in the near term, there are a couple of very important things the Fed working with the other banking regulators can do that will at least make real progress. Too big to fail won't solve it, but it will make real progress.

One is get the capitals in place and have a tough effective simple leverage ratio that continued reliance on these risk-based measures as a primary means of gauging large bank capital adequacy proving themselves to be inherently unreliable because they rely on conflicted management and inherently unreliable models to try to determine what the appropriate capital level is.

So you need risk-based measures but you also need a leverage ratio, a tough one. The Systemic Risk Council which I'd share has argued for an 8 percent leverage ratio. Tom Hoenig sitting here is going to tell them to go for it. Yeah, be still my heart. But getting the capital levels up and with a simple effective enforceable measure that cannot be—it's not as subjugating as these risk-based measures are, is really, really important and that [inaudible 35:37]. That could be done and if you're only near term.

The other thing that I think the Fed, working with other bank regulators, could do would be to require at the holding company level at these large financial conglomerates issue a minimum amount of debt—excuse me—long-term unsecured debt or equity of you and I, Simon, and along with a few other academics have the comment letter last summer arguing that they have a capital stock at least 30 percent, equal to at least 30 percent, of tangible assets that would be available clearly for loss absorption if one of these institutions fails and has to be put into a bankruptcy or an FDIC controlled bankruptcy process under Title II.

That would make sure, I think, the FDIC has come up with a viable strategy near term to resolve these very large financial conglomerates by taking control of the holding company. But you need to make sure there's enough loss absorption capacity at the holding company for that to work.

And Ben Bernanke, Dan Tarullo, and Martin Gruenberg, they've all spoken to the need to do this. I'm eager for those rules to come out. We filed our comment letter last July to get this in place because this will make sure that they're much more resolvable if one of them does get into trouble, number one. But number two, it's going to create more market discipline and increase in funding cost, which I think is a good thing, not a bad thing because this debt that they will be required to issue will clearly be available for loss absorption. I think bondholders looking to buy that debt are going to offer a lot of scrutiny of these banks and how safe they are before buying that debt and figuring how much of an interest rate they want to be paid for it.

So those are two big things in the near term that I think could go a long way to addressing too big to fail, which I hope the Fed acts on.

Simon Johnson: Okay. Thank you very much. I'll turn it back over to Adam.

Adam Posen: Yeah. Well, first off again, thank you to our guests who I think did a terrific job today really.

Adam Posen: Again, thank you to Simon for putting this together. He's one of the few people who can bridge so many audiences and people. But we're also grateful to INET, Institute for Economic Thinking, which has supported this event and a number of outreach efforts that Simon and others are doing through the Institute.

But as I've said, part of the point of the Institute's convening power is we want people of all serious views and this is a very obviously extremely serious view to have the chance to put their best case forward, but to also have the chance to be challenged in an open fashion and that their views are exposed not as shallow. They're serious views, but exposed to a critical consideration. And that's why we're shifting it over to all of you. And putting aside my own personal sympathies which are on the record on this issue; let me if I could just to get things started pose a couple of questions to our guests individually.

First, Sheila, your last response to Simon I thought was great talking about the nuances of the holding company and so on. But it sort of raises the broader issue. Today's event is about too big to fail. But we know that there were a bunch of other things that happened, right? We had AIG Financial Products. We had Household and Countrywide giving all kinds of mortgages. We had regulatory arbitrage across the country.

How far up do you think too big to fail is in the priority list? And more importantly perhaps—Dodd-Frank, for all its good intent and perhaps virtues is an incredibly complex document. If we're really worried about this, maybe we should be—leaving aside the political possibility I understand that—but just what we should be striving for. Maybe what we should be striving for is a utilities model or something Paul Volcker dreams of; a very strict Glass-Steagall restoration. Should we settle for this? Should we be going for something bigger? What's the priority here?

Sheila Bair: Well, I don't think you have to go so far. Though I must say, I frequently hear from large banks when regulators push for higher capital standards or the Volcker Rule or whatever, well, that's going to hurt the economic recovery. That's going to constrain credit. And I do think they're trying to have it both ways.

So one hand, they're saying, "Well, we're so big. If you increase our cost even a little bit, we're going to pull back lending. It's going to hurt the economy." So well that means they're too big if we can't require that they have an appropriate level of leverage and internal the cost of their operations that they make them be viable without implied government subsidies. Then I think that's a problem.

But I do believe Dodd-Frank gives the regulators the tools now to tease out those subsidies to force better market discipline on these financial institutions and to require a lot more transparency about their operations which could lead to market-driven solutions to break up.

If you look at the analysis that has been done of share performance of these large institutions compared to the smaller ones; the ones that just take deposits and make loans pretty much follow a traditional commercial banking model. The three megabanks, B of A, Citi, and JP Morgan Chase, have not performed well. I mean Chase clearly is much better than B of A and Citi. But even Chase does not compare well to the better managed regional banks.

So why are they this big? It's not showing up in shareholder returns at all. Mike Mayo did a recent analysis and one of the things you can't even tell. So there is a movement right now with this being led by Trillium Management to get Citi Group, the Citi Group board, to come up with analysis at least that will show us, you're trading a steep discount to your tangible book which suggest you're worth more liquidated than you are is a going concern. So give us a breakup analysis. We'd like to see whether you're going to be worth more in pieces.

But you can't do it now because the disclosure is so bad. So Citi and the rest of them—JP Morgan Chase is better—they won't show how they allocate capital expenses. They could say, "Oh well, our investment banking units got this great return on equity (ROE) and commercial banking is doing well on that." But you look at the returns in the holding company level and they're not so good.

So get the information out there. That's another thing that I think regulators could do that could help spur our market-driven solutions to this. I don't think most of these guys are economically viable make any sense at all. You can get rid of the government subsidies and then let the market downsize them. So that would be optimally the approach that I think would get us through the fastest.

But I think the regulators need to get more information out there to the market. And they need to make them simplify their legal structures now. They've got this morass of legal entities. It's like a poison pill. You can't figure out. You want to break them up. Where do you start? They have 11,000 legal entities. How are you going to do that? So I think those are very positive actions that the regulators could take if they were to do it now that could help lead us to market driven solutions as well.

Adam Posen: Thank you for the very practical response.

Jon, one of the reasons you have fans here, nothing partisan, is that we know you have an international background. You've talked trade with Fred Bergsten. You've talked China with Nick Lardy, all our people. And it was very heartening for us in your last response to Simon for you to start talking about China, and Japan, and the euro area. So let me draw you out a bit more on that.

One of the arguments that's made sometimes about pushing too big to fail as being problematic is the international side in at least two senses. First that, well, we can do this. We can regulate the three megabanks or whatever. But if the German, the Swiss, the British, the Japanese don't do the same and we have open markets, all the counterparty risk is there. So does this matter? Does this make sense without somehow achieving an international standard?

And the second piece of the international side, again, I'll be interested in your responses. Is this in the sense a form of unilateral disarmament? Taking Sheila's point about shareholder returns, I'm not going to deny the facts on that. But there's usually an argument made that both for tax reasons and for financing reasons it's good to have a national champion bank. It's good to have a bank at the cutting edge. France has BNP Paribas. Germany has Deutsche Bank. The United Kingdom has God knows what. But whatever it is, the United States can't do without that. So how do you think about those kinds of international arguments on the too big to fail issue?

Jon Huntsman: Well, in many cases, the risk is far more severe in other countries than it is here just given the size of certain banks as a percentage of GDP. And my guess is that at the international banking community although we do coordinate and that may be part of the problem, we're all making the same mistakes and maybe we had to kind of learn from those mistakes and move on a little differently. But we are still the heartbeat. We write the lyrics for international financial community. We are it with the epicenter.

And I think whatever is done here along the lines of assessing risk and dealing with the implied subsidy and the regulatory steps that might be envisioned going forward, I think it's likely going to impact the global, the international banking community because many are positioned in a way that we are, some even more severely. And given the fragile nature of the global economy and prospects for recovery, few signs of life here and there, you can't fully regain your strength without rebuilding a robust and fair financial system.

It has to be able to deliver seed corn to innovators and doers and entrepreneurs in ways that allow you to rebuild the machinery. And we're kind of right at a point, I think a key inflection point, in terms of our own recommitment to our own competitive base. I really do think the next few years could be very good for the United States. And I think the world will actually pay a lot of attention to how we begin to rebuild ourselves. But that has to start with a financial system that really does endeavor to get not only debt but equity, equity financing, into the hands of those who are prepared to rebuild our economy because the rest of the world is going to have to follow soon.

Adam Posen: Thank you. Sherrod, Senator Brown, if I could. One issue which you raised, not alone but first on the panel, was you made some remarks about the size of the financial sector in our economy and relative to manufacturing and that this was troubling to you in various ways.

In this House and in most places where economists congregate, we viscerally hate that kind of talk. We viscerally hate the idea that there's any particular sector that needs to be lionized, whether it's financial services or it's manufacturing, that there's nothing special on the countries that focused obsessively on manufacturing, for example, or focused on the rice farming, or focused on their banking system go astray.

Is there anything you want to say about that contrary to what the economists in general think that's just silly? Or is there something particularly bad about finance why it shouldn't be too big? How do you see that argument?

Sherrod Brown: Interesting point. Let me add something to what Jon said about our international—kind of international situation and then I'll try to answer your question.

Adam Posen: Always glad to have you comment on international stuff here.

Sherrod Brown: Europe uses a different accounting standard system to determine size of banks. And if we actually use their system for our banks, we'd have the three largest banks in the world. That's the first point I think to make.

Second is when—I think JP Morgan was made the $20 billion loan to AT&T to take over T-Mobile. They divided that among 11 banks. I mean it was so—it's not like—it's not as if we could have—it's not as if you don't put a package of regional large banks. I mean neither AT&T nor JP Morgan wanted the exposure of $20 billion on either firm's balance sheets ultimately. So that our argument I don't think works. I mean I hear it. It's sort of the first one they often say you can't do that. It takes away our competitive position in the world. It really doesn't—it undermines and it really doesn't do that at all.

First of all, much of what I—I'll start with my bias on your question. Much of what I do in the Senate and I did in the House is how do we rebuild American manufacturing. I don't think we are a global power in terms of national security or in terms of domestic security for our families unless we make more things. I see what happens to families and my hometown in Mansfield, Ohio when they see the kind of wage drop that they've seen when a plant closes and they're making $19 an hour. And now they're making $12 an hour if they have jobs and they are 40 and 50 years old. And the answer is, well, more highly skilled workers go to community colleges and all that. I hear that. That assertion is always made by people that dress like this and make policy, whether they're economists or politicians, far too often.

But second on a more practical to speak to the people that hate that statement is we were subsidizing. I mean we know what we're doing to subsidize financial services. I mean strip away all the bright kids from Princeton that go to Wall Street and don't come back and work on their father's company or their mother's company or just come back and want to be entrepreneurs and make things and strip away trade policy that does incent if incent—I think it's a verb I'm not sure—incent companies to go overseas.

And I'll give you one example about where we miss on innovation. It's a very simply example. It happened in—I was in Minster, Ohio right near where Neil Armstrong grew up in Wapakoneta. And that's the largest yogurt manufacturer in North America. It's a Dannon yogurt plant. And I went in there and I was—just, I love going to factories because I like to see things made. And I know that's built a future of my state as it is the country in many ways.

For years, they had bought their little plastic cups from a supplier. They were brought in and they squirted the yogurt out of these. They took the yogurt out of these big vats for many milk and squirted them into this plastic cups and sealed the cups on the line. And a young engineer, industrial engineer that looked to be about 12 to me with a couple of line workers said this is stupid. We can do this better. And they developed a machine not even from here to the other end of the room probably about from here to the other end of the room where they bring in rolls of plastic, feed the plastic into it; heat it, extrude it, cool it, fill it with yogurt in one move.

And that's where innovation takes place in the factory floor. And when we continue to have policies that cause us, for a variety of reasons, to do the innovation in this country and then move the manufacturing overseas, we lose our innovation edge. And we can talk economic policy and I think economic policy, whether it's taught in college or talked about on the hill, can work in a way that helps American manufacturing. And I just don't think it's showing a bias.

Larry Summers was in my office one day. And I was talking to him about that. And he said, "Well, we don't pick winners and losers," because I was talking to him about manufacturing. So we don't pick winners and losers. I said, "Well, our country really expects financial services as a winner in a whole host of policies for the last 25 years. I'm not asking you to pick solar over wind. I'm asking you to look at manufacturing and being a country that makes something."

Adam Posen: Well that's a debate for another day. And I hope the Senator will forgive me if I don't replace this hall with a yogurt extruding machine. But I do think there is a legitimate middle ground we have to pursue of not subsidizing certain industries. It's not the same thing as choosing to subsidize others. We can get away from all subsidies.

But, anyway, let me now turn open to the floor. Usual rules of the house. I want to ask that the first three questions come from people from outside the Institute. Please identify yourself when you ask a question. Please direct it to any member of the panel if you like. Part of the reason I'm standing here is so you can direct stuff to Simon as well. And we have a travelling mic. We have a mic in the back. Sheldon, I think you were first.

Sheldon Ray: Sheldon Ray, Morgan Stanley. On the subject of excessive executive pay in the banking industry, which has been a major factor, I believe, what does the panel think the effects of more deferred compensation clawbacks could have on the industry to unethical and irresponsible behavior? And if it does have a positive impact in the next few years, could the government mandate such and how?

Jon Huntsman: I think without needing a mandate, Sheila will correct what I say, I think without needing a mandate, compensation committees generally are kind of moving by themselves in this direction looking at best practices where more and more of the compensation is based on performance deferred clawbacks whatever the terminology is today.

I've seen just—having served on corporate boards over the years and still on a couple of a large ones, that there is more innovative thinking going toward compensation and basing it out of real results of the firm than ever before. And that's not driven by any sense of overall mandate. It's driven by a compensation that many of us saying we got a lot of eyes on it. It's like never before. The company has a lot of eyes on them and that should be motivation enough to kind of begin to do the right thing.

Adam Posen: Great. Sheila, do you want to add anything?

Sheila Bair: Yeah. I think Morgan Stanley has been doing some positive things in this area. And top management and boards should be focused on it. You know we have so much regulation now and self-prescriptive. Yeah, you can do this and you can't do that. And I think it's so much more effective to look at underlying economic incentives. What's driving the behavior to begin with?

And so compensation systems that are less geared towards swinging for the bleachers and more about staple a performance over time, I think, is absolutely a positive thing. You can debate whether the government should have a role or whether the boards should take a leadership. But whoever is doing it absolutely needs to be focused on this. And greater equilibrium between your variable pay and your base salary, I think, is a positive move.

I think using convertible debt as part of the variable piece of the pay package is good because with convertible debt, your upside is just your return, your interest on the debt. But you got a lot of downside if the bank gets into trouble. You got a lot of downside with convertible debt. So I think innovations along those lines are extremely helpful. And again tackling the economic incentives that give us the behavior, I think, can be a lot more effective than these prescriptive, highly prescriptive rules.

Sherrod Brown: And I would just add one sentence on that is I just think this pay packages that the public sees and I'm not really speaking only about Wall Street, but especially they just undermine people's faith in our government and in our economic system when they see this kind of pay.

I mean for 10 years, most of Americans had not gotten a raise when you get right down to it. Most of Americans see stagnant wages and costs go up. I mean that's a very small number of people have done very, very well, not just Wall Street but a number of companies and it just really does. I mean this really is a country where we thought for decades and decades we're in this together.

It sounds a bit platitudinous perhaps, but I do think it's something to think about. I'm not saying that government should come in with a heavy hand. I like what the governor said about compensation boards are getting a little more prudent about it. I hope they continue.

Adam Posen: Just for the record, your long sentence gives me excuse to plug some of the Institute's work. With the support of the ERANDA Foundation, we have a major two-year study underway on inequality across counties, what business activities can do about it, and how they contribute or not including Robert Lawrence, [inaudible 17:19], Jacob Funk Kirkegaard, and myself working on this. And so we are sharing that concern and trying to contribute to that discussion. At the back microphone.

Jo Marie Griesgraber: Jo Marie Griesgraber, New Rules for Global Finance. First, I want to say I'm very encouraged by the listening to this panel. I usually am horribly depressed. I wanted to ask two quick questions.

Whatever happened to trust busting in the United States? Don't those laws still exist on the books? And why isn't the Justice Department busting out some trust? Secondly, the Food and Drug Administration (FDA), we test at least medicines before they go on the market. Why can't financial innovations be tested beforehand for their impact? Then maybe management would understand what's going on?

And third, I want you to know that there is a wide-ranging coalition of lots of grassroots groups, small businesses, academics, religious working on FACT, Financial Accountability & Corporate Transparency, as our acronym drummed up over a good big bottle of beer one night. But I want you to know that there's active campaigning on these issues. And we would love to have you get engaged with it. Thank you so much, Adam.

Adam Posen: Welcome. Again, Jo Marie, I'm delighted to see you're bounding with enthusiasm. Sorry that was a joke, I guess not. You didn't direct the question, so if anybody want to pitch in on quick points.

Sheila Bair: Well, on trust busting, it's concentrated but they still compete with each other. So I think it can be difficult. I'm not an antitrust lawyer, but I've talked to antitrust lawyers who are more knowledgeable. And I still think there's still sufficient level of competition that using that check to tackle this. Under the current law, may not be what you can do.

On FDA, the FDA model product approval, preapproval, that had very short life with the consumer agency for consumer products and really got a very negative reaction, I think there's still, you know, since in this country we like innovation if it's responsible innovation. And their concern was that you would get into too much of a bureaucratic process whether that's right or not, I don't know.

I will say that we do have safety and soundness regulation, though, and consumer regulation of these institutions. So they're launching products that are abusive to customers or not safe and sound. There are rules in place and examiners whose job it is to go in there and find those that stopped it already. And I do believe that we need to be more proactive in using those regulatory tools and nip things in the bud. Don't let subprime get completely out of control before you figure out it's a problem. So I do think there's some current tools to try to stop abusive products before they get out of hand. But we need to use them.

Sherrod Brown: I would add only that your grassroots efforts I think we—I know I didn't mention. One of the reasons I think things have moved more quickly than most of us thought on a lot of these—what's happening in the Senate is because the grassroots efforts I think people are more educated on these issues, much more than they were five years ago the general public—I actually went through a really big reelection campaign. I mean big in terms of dollars and every other way. And I just saw the power of the internet better than I ever saw it as somebody that just turned 60. And I think that's what happening with grassroots efforts will have an impact on this too.

Pat Malloy: I'm Pat Malloy. I'm a trade lawyer and I teach trade law at Catholic University Law School. But I was 15 years on the staff of the Senate Banking Committee and I very much agree with Senator Brown's point that the strength of the financial community has had an enormous impact on trade policy in this country in the outsourcing. But I want to come to the other issue.

When I was on the Banking Committee staff, we did the Riegle-Neal Interstate Banking and Branching Efficiency Act. We were very concerned about the political strength of the financial community. And we decided and this was under Senators Riegle, Sarbanes, and Garn that we should put concentration provisions. And the Antitrust Division told us we didn't need them. But we said no. We're more concerned with the political strength. So we said if a bank gets more than 10 percent of the banking assets of the country, it can no longer expand by acquisition. And I always wondered what happened to that provision? How did they get around that to be able to get this enormous power?

Simon Johnson: Unfortunately [inaudible 21:39] concentration, you put the cap as a percent of retail deposits and this is in the mid-1990s. And the big expansion that we had, that we've all talked about since mid-1990s was not particularly in retail deposits, it was more of the loosely called wholesale funding.

Now, Dodd-Frank did change the language. So now if you have more than 10 percent of total liabilities of the financial system, you are restricted in terms of your ability to expand through acquisition. But still there are many included, I think, me and the panel can speak for themselves who feel that cap and Dodd-Frank is too loose. It's not binding. And even Dan Tarullo with the Fed has indicated that the Fed may take a tougher, more stringent, more restrictive view when they let banks expand.

Adam Posen: Simon, can you give us one to two more sentences on when you say it's not binding. Why is 10 percent on liabilities insufficiently binding?

Simon Johnson: Well, I think the issue to worry about there, Adam, is I think historically and comparatively about what happened in Japan in the 1980s which you know about more than anyone. But when you have—again let me speak loosely—some sort of bubble, some sort of expansion in the financial system that's not justified by the real economy or by what can be sustained in the future.

Financial liabilities will expand a lot relative to GDP. So banks could become very big even if they're only 10 percent of this much larger number. That's why I'm drawn very much to the cap on size of bank balance sheet relative to GDP; relative to the real economy because that's an indication of how much damage you can do to the real economy.

And again, I recommend strongly the Tom Hoenig adjustment which is essentially using international accounting standards over US generally accepted accounting principles (GAAP) to think about bank size with regard to potential danger. But that's banks relative to the real economy. It's simple and straightforward. It makes sense. It's somewhat more bubble proof than would be anything of percent of liabilities.

Adam Posen: Thank you for specifying. Again just to note, Simon and also Nicolas Veron on our staff are both writing about this comparison of using European versus American banking standards and what that does to how you understand bank size. Gentleman at the back microphone.

Speaker: Thank you [inaudible 23:41] with China's Xinhua News Agency. I have a question for all the panelists. What are your insights on the Troubled Asset Relief Program, the TARP program, in terms of too big to fail? If this program kind of worsening the too big to fail phenomenon, what lessons can we draw from this program? Thank you.

Adam Posen: I'm sure every member of the panel has some opinion on this. Sheila did write a book on this.

Sheila Bair: Yes. So, you know, getting back to Adam's earlier point about was too big to fail really that much of a driver during the crisis? It had a role. It wasn't huge. But I think a lot of Dodd-Frank was trying to fix the 2008 bailouts, the tremendous moral hazard that was created by bailing out all these institutions and going down to not that large. Pretty much in 2009, we said anything over $100 billion are going to bail out.

So I do think there was, you know. You did what you had to do. I was a part of this. I had concerns with some of it, which I voiced at that time and continue to voice. I think we did [inaudible 24:49] some of it back, but it is what it is. But it created tremendous moral hazard. And that's why Title I and Title II Dodd-Frank are really all about trying to identify institutions that are systemic early on and making them unsystemic, not to bail them out, but to make them unsystemic, to get to the point where they can fill on the bankruptcy. And there's a backup process in Title II which is basically an FDIC-run bankruptcy. But you still have the shareholders and the unsecured creditors taking losses as they do in bankruptcy.

So don't go there. Get ahead of it now. And this is why I personally and a lot of others have been frustrated with the slowness of doing Title I designations, which is basically the AIG provision just to give the government the tools to those who are not already subject to prudential supervision to identify those that are sufficient in size. It's really interconnectedness more than size that could have systemic impact.

Identify them early and supervise them and make sure they have living will process so they can demonstrate and make whatever structural changes they need, they can fill in a bankruptcy. So a lot of Dodd-Frank really was about correcting the 2008 bailouts, not so much—a lot of it was about the subprime crisis too. But a lot of it was undoing the damage of 2008.

Adam Posen: Very interesting perceptive.

Sherrod Brown: I remember very vividly I was in Zanesville, Ohio in September on a September day in 2008 when I went in a little town in Eastern Ohio called the industrial town that's had some [inaudible 26:11] and still a good place. And I got a call from majority leader's office saying that Secretary Paulson and Chairman Bernanke want to talk to the banking committee. This was at noon and he said he's going to call at 2:00. And that was when Chairman Bernanke sort of laid out the severity of all of this as much as you could in 10 minutes and then Paulson asked for a three-page bill for $700 billion, which elected officials don't always respond well to requests like that. We talked about it.

I remember I went home that night. My wife said she had never seen me quite look that way in terms of just how overwhelming and scary it was. And we did what we have to do as Sheila said. But often when facing a really complicated sort of difficult vote, I will just for myself not usually share it. I'll write down why vote for this, why not vote for this. And I remember at the top of it, I wrote the best vote I ever cast and the worst vote I ever cast. I mean you just knew you had to do it for this financial system. It also led to another thing probably Peterson Institute hates and that is the auto rescue but—

Adam Posen: No, no, actually [inaudible 27:21].

Sherrod Brown: Pure economist would know not that you're not a pure economist, but never mind. But I think that—I mean that was something, as Sheila said, we have to do what we have to do there. I think it was a generally success and I think it saved much, much disaster for our country.

Sheila Bair: And not one we want to repeat.

Sherrod Brown: Yeah. Exactly. That's really the significant thing we never want to repeat that situation, of course.

Adam Posen: Jon, did you want to—?

Jon Huntsman: [Inaudible 27:51] that's because I got sort of on board in that—

Adam Posen: I was impressed really. Yeah, I was really impressed.

Jon Huntsman: My colleagues have said it all.

Adam Posen: On that note, Ted Truman and then the lady in front here.

Ted Truman: So I want to thank the Senator for making Adam's day—

Adam Posen: This is Ted Truman.

Ted Truman: Ted Truman on Peterson Institute for International Economics. But I want to comment that you made Adam's day by calling him an impure economist.

So my question is on this too big to fail question is that notwithstanding the fact that I don't think we have much facts about the advantages of size and scale and so forth and so on. I think the literature is pretty weak on that. I could blame actually the academics as much as the politicians on this and the regulators.

But I'm having trouble getting off and getting my hands around the fact that we need to distinguish between dealing with an individual institution which gets into trouble and liquidating it and a general lemming effect which affects all institutions, large and small. The best example, recent example in the United States, of course, is the savings and loans institutions, savings and loan crisis which were a bunch of small institutions not withstanding if there were some regulatory flaws that led to the capacity to be lemmings. But the point is they were all lemmings in this case.

And when you have a systemic problem in terms of a bubble if you want to put it that way whether you're dealing with institutions which are 10 percent of GDP or 5 percent of GDP or 3 percent of GDP, you end up in the same general situation. So I'm interested in anybody on the panel who wanted to comment on the distinction between the individual institution that's too big to fail and the systemic problem of many institutions at the same time who may end up having to be, for many of the same reasons, rescued. I don't use the word bailout for obvious reasons because of my own background. Thank you.

Sheila Bair: So I think this is also something I talked a lot about in my book. I think it's fallacy to think of this crisis as something that everybody did. Certainly, everybody made mistakes, but there were clear outliers here. Institutions that were clearly insolvent that should have gone through some type of bankruptcy restructuring that did not. And we did get to the point where the market got so confused towards the end of 2008 that the funding markets seized up. And that was creating a particular problem for those who relied on a lot of wholesale funding even those who did have an adequate capital base.

But the traditional commercial banks that did not do a lot of the stupid things and had good strong deposit franchises and higher capital levels because we had fought off this [inaudible 30:42] advanced approaches for them. So they had higher capital levels. They really were not in trouble. And I think it's fallacy to think this whole thing which is everybody was in trouble. That's just not the case. There were clear outliers.

And going forward with the Dodd-Frank framework is, is that you now have a process for the insolvent institutions; actually Dodd-Frank requires that they be run through either bankruptcy or government control-based bankruptcy that will be run by the FDIC. And you do if you have a true system-wide problem. There is the ability to provide some general available system-wide support for solvent institutions. And gosh even if we ever did get into a system-wide seizing up of public confidence where there'd be liquidity problems for otherwise healthy institutions and we certainly saw that in the wake of the market crash of 1929, you would have these multiple tools.

But the insolvent ones and they're there and you know that they are. The regulators knew who they were. The markets knew who they were. We weren't kidding anybody. Now, they will go through a bankruptcy run process and they will be restructured and that's what you want. It's not punitive. It's not justice. Maybe it's a little bit of that, but it's what works for the economy to prop up these very sick institutions with these huge volumes of legacy assets.

These banks don't go out and do a lot of real lending. They nurse their balance sheets. They deal with their litigation. They deal with their loan restructuring. They're not going out there and making these small business loans. Restructure them. Get them cleaned up. Put the bad assets into bad banks. Spin off a good bank, one that's got good capital, and go out there and loan. That's what helps with the economic recovery and that's the piece that we didn't really do in 2009 and we should have.

Adam Posen: Yup. That's great. The lady in front here.

Nancy Jacklin: Nancy Jacklin, Johns Hopkins SAIS. I'd like to drill down a little bit on living wills which you mentioned which is really the existing nuclear weapon that already exists in our laws to try to deal with banks that are too big to fail, too big to manage. And I wonder whether the reluctance for faster action or more action what the politics are both internationally and domestically that are kind of preventing some real movement in this.

Because I think all of us who have worked on the issue of too big to fail for 20 or 25 years knows it's going to be a very long time before the international legal system has a regime that permits a multinational bank that's highly interconnected to be wind up in an orderly way that doesn't create systemic risk by announcing the winding up, right?

And so why isn't this happening? I mean you have the universal banks in Europe? Is it the international political resistance to try to restructure the system differently? How much of it is just an unwillingness of Congress to tell regulators to do the job that they are permitted to do under Dodd-Frank? Why are we not focusing in on the powers that are already there, right? We don't need new laws basically to solve this problem.

Adam Posen: Thank you.

Sheila Bair: Well, I agree with you. I'd like to see it. There are powerful tools there. And I would like this ending too big to fail to be a much higher priority or singular focus that our regulatory system should now be to make sure that the markets understand the cost of risk-taking would be borne by them, not by the government, not by taxpayers.

That by itself will make our system so much more stable. And it's been said if we'd let one go down and we'd let Citi Group go down that would have probably had a much bigger impact than all the rules we are writing now. And so why this isn't a higher priority, more urgent priority, and why there isn't a more muscular approach?

You know I agree with you. On the international front, I mean Europe just has very byzantine way of making decisions on anything including this. But the United Kingdom is a little more nimble and I think there have been a lot of tremendous progress through the work of the FDIC, and the Bank of England, and the Financial Services Authority (FSA), which will soon become part of Bank of England to come up with the memoranda of understanding and protocols.

And really if you get the United States and the United Kingdom, you've got a big, big chunk of the global financial system because certainly most of the US firm's foreign operations are regulated through the UK system. And so at least in our space I think if you get agreements there and there are agreements there already, you've gone a long way towards coming up with a viable model for resolution. What I discussed earlier, higher capital loan and making sure there's enough debt at the holding company level to absorb loss, which is very important and that can be done in the near term.

Adam Posen: Before the other panelists respond, I just want to follow up momentarily on Nancy's point and sort of link it to Ted's lemmings point. One way and I'm sympathetic to this. It goes to some points that a number of you made about cognitive capture. It's not outright corruption, but they listen to people who maybe don't look like me and look like Jon Huntsman.

But anyway, they listen to people in gray suits talking this. And the academics all fell in, and the policymakers in both the Clinton and Bush administrations fell in, and the Fed people fell in. So I guess the question is, if part of what happened was there were rules on the books and it's a matter of choice or intellectual climate, the people in charge chose not to keep the rules up to date, for example, in the way Simon was talking about with size issues or chose not to enforce them.

Is there anything we can do about that or is it we just hope that every few years we catch up and smack the regulators around and say, "Hey, wake up?" I mean there's a serious point here. I mean that doesn't mean you shouldn't try. But it means realistically what do you do to actually stiffen the spine so that the intent of the law when passed in 1980 is still enforced in 2010. Okay. Start with Sherrod.

Sherrod Brown: Well, I guess you said it. I think we try. This whole idea of—it seems there are sort three approaches. There's figure out ways to do regulation better, but we know just the fact that all the Dodd-Frank rules have taken three years and they're still not written, let alone implemented and enforced. And obviously the vocal rule is the most salient of them. Second is you do better capital standards and better quality capital and stronger standards and you tier them as Sheila said. And third, you find some ways to limit liabilities and limit debt.

And I think you need to do all of these tracks and probably—I mean there's also in Congress discussion of what do you do with Glass-Steagall. And I think there's some cause for optimism because I—I don't know a whole lot about depression era, banking rules, and kind of what came out of that. But it wasn't just one bill that passed Congress and one law that President Roosevelt signed. It was Glass—I believe Glass-Steagall was the first major one. And then there was movement after that when they saw other things that needed to happen. And I think that Dodd-Frank is not the only thing we're going to do. And I think over the next two or three years, we will see other things that Congress looks at doing.

Jon Huntsman: I think it's important to capture the moment and remember where we are. We're just coming up for air after some really difficult years. I think we downplay the extent of the fear factor somewhere between 2008, 2009, and 2010. I remember so well as a governor meeting with the National Governors Association behind closed doors with Bernanke and hearing how close we had come based on his description and how fragile the system was.

And I think when you've got banks that are unhealthy, they don't lend. When you've got politicians and regulatory leaders who are insecure, they don't lead. And I think the whole system was frozen for a lot of that period. The mechanics were there for us to follow. The rules are on the books. But who leads out and gets it done? I think we were frozen in time. That's why this moment now I think is so very, very important. We can reflect back, do an autopsy of sorts, and figure out how we move on in terms of our regulatory fixes, deal with subsidies, level the playing field, and begin to prepare for the next phase of growth.

Adam Posen: Great. I don't want be rude, but we have two more questions. So could I ask Simon and Sheila to hold off on that.

If I could, I'd just like to ask. I'm not trying to put people on the spot. But I'd like to ask the two people to pose their questions and then we'll get final comments from the panel, please.

Speaker 2: [Inaudible 38:46] with the *Financial Times*. You know I've been writing about too big to fail a lot over the last couple of years. And one thing that's always—arguments always made to me by those who are against either breaking up institutions or putting a size cap is they bring up. They say that the issue isn't so much that some institutions are too big to fail, that rather they're too interconnected to fail. So they bring up, for example, or in some cases Lehman Brothers.

And so I'm wondering if the concern from your perspective is it more of a financial stability concern that these institutions are too interconnected so they must be reduced somehow in size or scope so as to limit those interconnections? Or whether there is a greater concern or fact that some of these institutions enjoy an unfair subsidy due to their size? They're too concentrated in the financial system. They dominate too much of retail markets etc.

I guess which is the greater concern? Is it more kind of the bigness of the institutions and the cost that imposes on the economy? Or is it kind of the interconnections and the implications for financial stability? Because if it's the latter, I wonder if it wouldn't be more prudent to simply impose really strict and stringent single counterparty credit limits where you effectively limit the ability of institutions to have various exposures. And so I'd be grateful to get your thoughts.

Adam Posen: It's a long question, but it's pretty specific. So we should be able to get some good answers out of that.

Tom: Tom Glessner from [inaudible 40:02] Investment. I had either the good pleasure or misfortune of being in Citi Group for six years during the crisis.

So my question after witnessing what I thought was abysmal risk-governance for a protracted period of time. And since many of you talked a little bit about, sort of skirted that. You know you sort of talked a little bit about that. I'd be very interested to hear anyone on the panel. What changes would you like to see in the risk governance process all the way down to chief risk officer, because at the end of the day, traders have probably undue influence on lots of institution? There are lots of interesting reasons why. It's a very complex kind of micro-risks, but it would be interesting to hear.

Adam Posen: Thank you very much. So we have two. This panel has been great showing their depth of knowledge and engagement. And we have two very substantive questions to go out on. And I do want Simon to also get the chance to talk. So why don't we start with Simon and then just run across the panel?

Simon Johnson: Shane, to your question, nobody ever said making the bank smaller was a sufficient condition for financial stability. The point is it is necessary. You need it as part of other safeguards you put into place. And I would stress the Safe Banking Act proposed by Senator Brown is not just about size.

It’s also about restricting leverage and a big part of our problems with interconnectedness come because we allow so much leverage to build up. Bear Stearns and Lehman Brothers were, as you know, very high—among the most highly leveraged institutions we’ve ever allowed to operate in this country.

They were not big in the sense of JP Morgan Chase which is fortunately in dollars under the Hoernig measure, they were about $500 billion to $600 billion. But they were big enough with a lot of leverage. And there are other things that you should consider including their counterparty caps.

And Tom, I think you put your finger on it. And Jeremy Stein, governor of the Federal Reserve, said something very similar in a recent speech. It’s profound failure of governance repeatedly in these large complex financial institutions. And I don’t think there is a fix from the outside or from inside that will comprehensively and forever remove that danger. You need multiple safeguards. And again, I think you need something very much like the Safe Banking Act, very much like what Jon Huntsman is proposing on fees and on capital [inaudible 42:13] and very much what Sheila Bair is proposing in her book.

Adam Posen: Sheila.

Sheila Bair: So if I have to pick between size and interconnectedness, I would clearly go with interconnectedness. I think size gets into some problems too especially with market dominance and political influence. But in terms of immediate shocks to the systems, it’s the interconnected firm that worries me a lot more.

And I think a big bank that takes deposits and makes loans, even a trade and dollar bank that takes deposits to make loans. I don’t worry about them so much because I know they got a stable funding base. I know there’s established resolution mechanism to deal with them. It’s easy to break them up geographically and figure out what to go where, but if you get a big [inaudible 42:54]. They got a lot of wholesale funding. It’s a real nightmare.

And so I think you have to recognize interconnectedness problems in a context of defining too big to fail institutions. And you have to look at the credit exposure absolutely as part of the living will process. One that’s not looked at as much as it should be, but there’s something called credit exposure reports, they’re supposed to be a part of the living wills and these big banks are supposed to—or anybody over $50 billion in assets is supposed to identify.

Okay. If I get in trouble, who else is going to go down because I'm in trouble and vice versa? Who else is out there if they get in trouble is going to take me down? Identify those in advance and get rid of them. So, again, it's another tool, a very powerful tool that regulators have, are they using them.

In terms of how they compensate key chief risk officers, I think they should be compensated very well. Their value is every bit as important as the traders that may be on a one-off basis can shoot for the moon and generate a big deal and also potentially put a lot of risk on the financial institution's balance sheet as well.

I don't think chief risk officers should be paid based on trading profits. I like to gather they get big bonuses when the hedges they put on correlate with the underlying risk. Wouldn't that be nice? You know a perfect correlation should get you a really big bonus if you're a chief risk officer. So those are kinds of things they wish their management would think about in terms of how they compensate people who have a very important function which is to keep them out of trouble.

Adam Posen: Jon.

Jon Huntsman: I think interconnectedness aside, I got to say that probably the subsidy issue is the one that is going to drive the debate more than anything else from a political standpoint because I think that's inexorably tied to the whole issue of trust with a system that seems to be rigged against a lot of players.

And so when you're facing a trust gap as it is in politics generally and you overlay yet an additional trust gap on the financial services side which has always been a centerpiece of trust and believability at least in my years growing up and that begins to change. I think you see a very serious eroding of people's view of our institutions of power whether they'd be politically or financially directly tied to the whole subsidy issue. And that's where I think this discussion kind of ends up going longer term and why I do believe it's going to be an issue to be dealt with at some point.

And with some risk for the sake of risk, Tom, is it's a good thing. We wouldn't be where we are without risk but also understanding that with that assumption of risk the institution might go down as well might tamper decision-making a little bit particularly on the trading side and the development of fancy financial instruments.

Sherrod Brown: I think the easiest answer, but also the best political strategy and the best substantive answer is all of the above. I mean we have a system that encourages too much risk in those that are the [inaudible 45:40] the banks that can cause the most damage. And that's why I think that the path we take is sort of all of the above both in terms of political strategy because there are different kinds of coalitions of support of the Senate so far and I think among a lot of people that are interested in this for different approaches. And I think all of those approaches have merit and should sort of be worked on both independently and cooperatively. So I guess I just say all of the above is the easy out answer.

Adam Posen: It's not easy if you're willing to carry water for the Senate. So thank you all for coming this morning. I think we did have an extremely engaging discussion on the critical issue in which there are obviously a hundred points of view out there. But it really is a fascinating thing to have Senator Brown, Governor Huntsman, and Professor Bair come together, all of them with a different political and experience backgrounds to talk about these issues so deeply. And special thanks to Simon Johnson and to INET for helping us put this together. And we'll look forward to seeing you again in another event very soon. Thank you all very much.